Board of Governors of the Federal Reserve System

REPORT ON THE AUDIT OF THE FEDERAL RESERVE'S IMPLEMENTATION OF THE RISK-FOCUSED APPROACH TO SUPERVISING COMMUNITY BANKS

OFFICE OF INSPECTOR GENERAL

(A9709)

March 1998

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

March 31, 1998

The Honorable Susan M. Phillips
Chairman, Committee on Supervisory and Regulatory Affairs

We are pleased to present our final *Report on the Audit of the Federal Reserve's Implementation of the Risk-Focused Approach to Supervising Community Banks* (A9709). The purpose of the audit was to evaluate the Federal Reserve's experiences in developing and implementing the joint Federal Reserve/Federal Deposit Insurance Corporation risk-focused framework for the supervision of state-chartered community banks and to provide early feedback to assist the Board in fine tuning the System's process for conducting risk-focused examinations.

Overall, we found that the Federal Reserve System is making substantial progress in adopting a risk-focused approach for supervising community banks. In our opinion, the joint development and implementation of the risk-focused examination framework is an important initial step in achieving consistent supervision of state-chartered banks.

While solid progress has been achieved to date, we believe that opportunities exist to further improve the process. Our eight recommendations to the Director of the Division Banking Supervision and Regulation (BS&R) are designed to enhance the efficiency and effectiveness of the risk-focused framework for examining community banks as well as coordination between the federal and state banking regulators.

Appendix 1 contains the director's response to the draft copy of this report. His response includes a discussion of specific actions taken or proposed to be taken which appears to indicate general or partial agreement with six of our recommendations. While the director appears to disagree with two recommendations, he intends to carefully consider each recommendation as BS&R proceeds to fully implement the risk-focused framework for community banks.

We are sending a copy of this report to each member of the Board, to each Reserve Bank president, and to selected staff. The report is available to the public and a summary will appear in our next semiannual report to the Congress. We are also making the report available on our Internet web page at *http://www.ignet.gov/ignet/internal/frb/oighome.html.*

Sincerely,

Brent L. Bowen
Inspector General

Enclosure

Board of Governors of the Federal Reserve System

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EXECUTIVE SUMMARY

Background

The Board of Governors of the Federal Reserve System (the Board) supervises state-chartered banks that are members of the Federal Reserve System. In fulfilling this mission, the Board's Division of Banking Supervision and Regulation (BS&R) formulates and administers bank supervision policies and procedures, and the Reserve Banks, acting under delegated authority from the Board, conduct safety and soundness examinations and coordinate with state banking regulation departments. The frequency and scope of examinations are determined by law and Board policy, which take into account the bank's asset size, complexity and supervisory rating.

The Federal Reserve recently implemented a risk-focused approach designed to concentrate bank examinations on activities posing the greatest risk exposure. Unlike the traditional examination approach that emphasized financial analysis and transaction testing to assess a bank's financial condition, the risk-focused approach emphasizes identifying an institution's significant activities, assessing the associated risks, and analyzing a bank's risk management systems and internal controls. To promote consistent examinations, the Federal Reserve and Federal Deposit Insurance Corporation (FDIC), which supervises state-chartered, non-member banks, implemented (in October 1997) a common framework and procedures for conducting risk-focused examinations of community banks.

Audit Purpose

We performed our audit to evaluate the Federal Reserve's experiences in developing and implementing the joint Federal Reserve/FDIC risk-focused framework for the supervision of state-chartered community banks and to provide early feedback to assist the Board in fine tuning the System's process for conducting risk-focused examinations. To accomplish this objective, we assessed the policies, procedures, and practices used to plan, conduct, and communicate the results of risk-focused examinations of community banks.

Results

Overall, we found that the Federal Reserve System is making substantial progress in adopting a risk-focused approach for supervising community banks. The joint Federal Reserve/FDIC framework for community banks focuses examiner attention and resources on areas that pose the greatest risk to an institution's safety and soundness while enhancing efficiency and reducing supervisory burden. In our opinion, the joint development and implementation of the risk-focused examination framework is an important initial step in achieving consistent supervision of state-chartered banks.

While solid progress has been achieved to date, we believe that opportunities exist to further improve the process. The following recommendations, which are discussed in the body of the report, are designed to enhance the efficiency and effectiveness of the risk-focused framework for examining community banks as well as coordination between the federal and state banking regulators. Specifically, we recommend that the Director of BS&R

- expand ongoing coordination with federal and state regulators to achieve a uniform, risk-focused examination program for state-chartered banks;
- revise supervisory policies that are incompatible with the risk-focused examination approach;
- issue supplemental guidance to integrate the Federal Reserve's six risk assessment criteria with the CAMELS rating format in the joint Federal Reserve/FDIC framework for examining community banks;
- revise the content of examination reports to reflect the risk-focused examination approach;
- provide opportunities for division analysts, who are responsible for developing examination policies and procedures, to participate in field examinations;
- add an on-the-job training component to the existing training program to help less experienced examiners develop skills required to conduct risk-focused examinations;
- communicate directly with Reserve Bank examiners to reiterate the division's commitment and support of risk-focused examination practices; and
- establish a process to monitor the System's progress in implementing the risk-focused approach to bank supervision and to disseminate information on what are judged best practices.

Analysis of Comments

We provided a draft copy of this report to the BS&R Director for his review and comment and requested that he indicate whether or not he concurred with our recommendations. His response discusses numerous efforts taken by the System to develop and implement the risk-focused supervision framework for community banks. The director appears to generally agree with recommendations to improve coordination with other regulators, update supervisory policies, give BS&R analysts opportunities to participate in field examinations, and monitor the System's progress with the risk-focused approach. He appears to only partially agree with our recommendations to enhance on-the job examiner training and directly communicate to examiners the division's commitment to risk-focused practices. He appears to disagree with our recommendations to link risk assessment criteria with examination procedures modules and streamline reports of examination. We plan to review the System's overall progress with the risk-focused approach during our follow-up on this audit (see page 15).

BACKGROUND

The Board of Governors of the Federal Reserve System (the Board) supervises state-chartered banks that are members of the Federal Reserve System. The Federal Reserve derives its authority to conduct safety and soundness examinations of state member banks from the Federal Reserve Act, as amended. The Reserve Banks and the Board's Division of Banking Supervision and Regulation (BS&R) each play a role in fulfilling the Federal Reserve's supervisory responsibilities for state member banks. The Reserve Banks conduct examinations under delegated authority from the Board, while BS&R formulates and administers supervision policies and procedures, oversees and coordinates the supervisory work of the Reserve Banks, and reviews enforcement and other actions taken under delegated authority. An examination is required at least once during each twelve-month period for all depository institutions; however, certain well-managed banks with assets of less than $250 million may be examined every eighteen months. During 1996, the Reserve Banks conducted about 600 examinations, some jointly with the state agencies, while state banking departments conducted over 300 independent examinations of member banks. Overall, the Federal Reserve devotes considerable resources to bank examinations; 1996 direct costs are estimated at $49 million.[1]

Traditional Examination Approach

Historically, the examination process centered around assessing key aspects of a bank's financial profile to determine a rating for each of the CAMEL components — capital, asset quality, management, earnings, and liquidity.[2] In determining these ratings, examiners relied heavily on traditional financial analysis and reconciliation techniques and, in some areas of the examination, significant transaction testing. These techniques included the detailed review of loans, investments, and other balance sheet and income statement categories, as well as certain off-balance sheet activities. The focus of such analysis and transaction testing was on static financial statement data, various regulatory reports, and additional information provided by a bank's management. The analysis of static indicators allowed examiners to make an assessment of a bank's financial condition and management practices at a point in time.

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[1]These costs comprise $47 million in expenses incurred by the Reserve Banks to conduct commercial bank examinations and $2 million expended by BS&R to develop and maintain supervision policies and coordinate Reserve Bank activities. Support and overhead expenses are not included.

[2]The rating system is now referred to as CAMELS because effective January 1997, the federal supervisors added "S" for "sensitivity to market risk" to the original five CAMEL components.

Evolution of the Risk-Focused Approach

Recognizing that rapid innovations in banking and financial markets have given financial institutions an increased ability to quickly and significantly alter their risk profiles, the Federal Reserve moved to integrate traditional transaction testing and financial analysis into a broader evaluation of a bank's activities. Accordingly, greater supervisory emphasis has been placed on ensuring that banks follow sound risk management processes and have instituted strong internal controls. In November 1995, BS&R established a policy requiring examiners to assign a formal supervisory rating to the adequacy of an institution's risk management processes, including its internal controls. The policy requires that the assessment of risk management and internal controls be given significant weight when evaluating management (M) under the CAMELS rating system. Elements of a sound risk management system cited by the policy include active board and senior management oversight; adequate policies, procedures and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls. Examiners are responsible for determining the risk management rating based on an assessment of an institution's ability to adequately identify, measure, monitor, and control the risks involved in its various activities. According to BS&R policy, six risk types (shown in the chart that follows) are evaluated during examinations.

Risk Type	Definitions
Credit	the potential that a borrower or counter party will fail to perform on an obligation
Market	risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices
Liquidity	the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain additional funding, or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions
Operational	the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforseen catastrophes will result in unexpected losses
Legal	the potential that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a banking organization
Reputational	the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions

In May 1996, BS&R issued the policy implementing the risk-focused approach to supervision. Under this approach, the resources devoted to assessing a bank's risk management processes are generally increased, while the degree of transaction testing conducted during an examination is adjusted depending on the adequacy of management practices and the materiality of the activities or functions being reviewed. In addition, risk-focused supervisory reviews emphasize up-front planning and scoping to ensure examiner resources are concentrated on high risk areas.

In conducting risk-focused reviews, examiners perform a risk assessment in advance of on-site supervisory activities. As part of the risk assessment process, examiners are responsible for identifying significant activities at an institution, evaluating the types and quantities of risks associated with these activities, and assessing the quality of the management and control of these risks. The risk assessment process highlights both the strengths and vulnerabilities of a bank and provides the foundation to determine the procedures to conduct during an examination. Once the risk assessment process is completed, examiners prepare a scope memorandum that provides a detailed examination strategy and assigns specific responsibilities to team members.

As discussed above, the amount of review and transaction testing necessary to evaluate particular functions or activities of a bank generally depend on the quality of the process used by the institution to identify, measure, monitor, and control the associated risks. When the risk management process is considered sound, then procedures are limited to tests of the integrity of the management system. But, if initial inquiries into the risk management system raise material doubts as to the system's effectiveness, then more extensive tests are performed to ensure that the bank's exposure to risks from a given function or activity can be accurately evaluated. More extensive transaction testing is also conducted for areas that comprise the most significant portions of an institution's activities.

Framework for Risk-Focused Supervision of Community Banks

To promote consistency in the risk-focused approach across the Federal Reserve System, two work groups were formed to develop additional guidance on the procedural details of risk-focused supervision. One work group concentrated on developing a framework for risk-focused supervision of large complex banking organizations, while the other work group developed a framework for community banks (non-complex institutions with assets generally less than $1 billion). In light of the Riegle Community Development and Regulatory Improvement Act of 1994, which mandated a unified examination approach among federal agencies, the Federal Reserve worked jointly with the Federal Deposit Insurance Corporation (FDIC)—which supervises state-chartered, non-member banks—to develop the framework for risk-focused supervision of community banks. The joint Federal Reserve/FDIC framework and related procedure modules have been automated in a software application named the Examiner Laptop Visual Information System (ELVIS). The joint Federal Reserve/FDIC framework was formally adopted by both federal agencies on October 1, 1997.

The framework replaces the Federal Reserve's Work Documentation Program (WDP) and includes examination procedure modules that address the six areas necessary to determine a bank's CAMELS rating, with supplemental modules available if other activities present significant risk to the bank.[3] To allow examiners the flexibility to use their professional judgement, the modules establish a three-tiered approach for the review of a bank's activities.

The first tier is the core analysis, which includes a number of decision factors that should be considered when evaluating the potential risk to the bank. To help determine whether risks are adequately managed, the core analysis section contains a list of procedures that may be considered for use by examiners. If the risks are properly managed, examiners can conclude the review and carry any comments to the report of examination. Where significant deficiencies or weaknesses are noted in the core analysis section, examiners are required to complete the second tier—an expanded analysis—for those decision factors that present the greatest risk to the bank. The expanded analysis provides guidance to determine if weaknesses are material to the bank's condition and if they are adequately managed. If the risks are material or inadequately managed, examiners must complete the third tier—an impact analysis—to evaluate the impact of deficiencies identified in the core and expanded analyses and the bank's overall financial condition. The impact analysis section also directs examiners to consider possible supervisory enforcement actions.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to evaluate the Federal Reserve's experiences in developing and implementing the risk-focused framework for the supervision of community banks, and provide early feedback to assist BS&R in fine tuning the System's process for conducting risk-focused examinations. Specifically, we wanted to determine if the framework for risk-focused community bank supervision, including the examination procedure modules, helped (1) focus examiner resources on banks'

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[3]In 1994, BS&R implemented the WDP, which incorporated traditional examination procedures to provide a consistent format for documenting tasks performed by Reserve Bank examiners. The WDP was intended to allow examiners some flexibility in determining the scope of supervisory reviews and applicable work steps to be completed during an examination. In practice, however, many Reserve Bank examiners viewed the WDP as a comprehensive checklist of procedures that had to be conducted on all bank examinations.

highest risks, (2) ensure effective assessments of banks' risk management systems, and (3) promote examination efficiency and consistency throughout the System.

To accomplish our objective, we reviewed the System's supervision policies, procedures and guidance for risk-focused examinations of community banks. We also reviewed work papers and reports for fourteen examinations conducted in 1997 by five different Reserve Banks and interviewed staff and officers responsible for these examinations. We also interviewed officers and staff from BS&R as well as representatives from the FDIC. We focused our efforts on providing a timely analysis of early experiences with the framework for risk-focused supervision of community banks to assist BS&R's ongoing efforts to implement this fundamental change in the examination program. We conducted our audit in accordance with generally accepted government auditing standards during September and October 1997.

FINDINGS AND RECOMMENDATIONS

Overall, we found that the Federal Reserve System is making substantial progress in adopting a risk-focused approach for supervising community banks. The joint Federal Reserve/FDIC framework for community banks focuses examiner attention and resources on areas that pose the greatest risk to an institution's safety and soundness while enhancing efficiency and reducing supervisory burden. In our opinion, the joint Federal Reserve/FDIC development and implementation of the risk-focused examination framework is an important initial step in achieving consistent supervision of state-chartered banks.

While solid progress has been achieved to date, we believe that opportunities exist to further improve the process. The following recommendations are designed to enhance the efficiency and effectiveness of the risk-focused framework for examining community banks as well as coordination between the federal and state banking regulators. Many of these recommendations could also apply to the implementation of the Federal Reserve's risk-focused framework for large complex banking organizations.

1. We recommend that the Director of BS&R expand ongoing coordination with federal and state regulators to achieve a uniform, risk-focused examination program for state-chartered banks.

The Federal Reserve Banks have traditionally coordinated supervision of state member banks with state banking departments, through either joint or alternate-year examination programs, to maximize efficiency and reduce supervisory burden. Recently, the Federal Reserve has taken a number of steps toward coordinating federal and state supervisory efforts to achieve seamless supervision and consistency in the examination of state-chartered banks. As a result of the Riegle Community Development and Regulatory Improvement Act of 1994—which mandated a unified examination program for federal banking agencies—the Federal Reserve, the FDIC, and the state banking departments signed two significant interagency Protocols and Agreements to (1) provide for a seamless supervisory process, (2) ensure flexible supervision commensurate with an organization's risk, and (3) minimize regulatory burden and cost. A State/Federal Working Group, an interagency working group between the Federal Reserve, FDIC, and the Conference of State Bank Supervisors (CSBS), was also formed to enhance the coordination and efficiency of state-chartered bank examinations. In addition, the Federal Reserve and FDIC, with input from the CSBS, developed a common framework for risk-focused examinations of community banks and formed a joint task force to identify ways of maintaining its effectiveness. While we endorse the Federal Reserve's coordination efforts to-date, we believe further efforts are necessary to achieve interagency consistency with the risk-focused examination program and to gain the full support and participation of state banking departments.

The Federal Reserve and FDIC have not finalized a process for (1) developing and implementing consistent examination policies and procedures and (2) updating the framework modules, related procedures, and automated software. We believe that these steps need to be taken to promote interagency consistency of bank examinations. Furthermore, a number of state banking departments have not adopted the joint risk-focused examination program for community banks. Since the Reserve Banks coordinate examinations of state-member community banks with state banking departments, a common examination approach among federal and state regulators is needed to promote consistency and reduce supervisory burden. We believe that opportunities exist to increase adoption of the joint risk-focused examination program by state banking departments through ongoing efforts by the Reserve Banks with the individual states in their Districts and through Federal Reserve participation in the State/Federal Working Group.

2. We recommend that the Director of BS&R revise supervisory policies that are incompatible with the risk-focused examination approach.

In developing the risk-focused approach, BS&R realized that certain supervision policies designed to guide traditional, transaction-oriented examinations were incompatible with the philosophy and practice of the new examination process. To address this issue, the System formed a task force to identify supervisory policies that could hinder implementation of the new approach because they require examiners to perform certain procedures without considering whether doing so would make sense in the context of the institution's risk profile. One of the most significant examples is the policy that mandates a minimum loan review coverage of 40 percent for state member banks with satisfactory supervisory ratings. Many of the examiners we interviewed told us that a stringent requirement to obtain such a large sample of loans for healthy, stable institutions that capably manage risk and have good internal controls, eliminates examiner judgment in a key area and stymies full implementation of the risk-focused concept. While a concerted effort to change these policies was deferred, we believe that BS&R can now use the task force's work to focus more attention on reviewing and changing supervision policies that impede risk-focused examinations.

3. **We recommend that the Director of BS&R issue supplemental guidance to integrate the Federal Reserve's six risk assessment criteria with the CAMELS format in the joint Federal Reserve/FDIC framework for examining community banks.**

Board policy for evaluating an institution's risk management systems identifies six risk factors that can be applied to banking activities: credit, market, liquidity, operational, legal, and reputational risk. Guidance from the Board implementing the risk-focused supervision process emphasizes the importance of examination pre-planning for identifying significant activities and evaluating the level of associated risk. These preliminary risk assessments are to include an analysis of the six risk types applicable to the activities being considered. The joint framework for risk-focused supervision of community banks, however, calls for a risk assessment addressing the CAMELS components, and the examination procedure modules included in the framework are designed around the CAMELS rating scheme.

Our review of examination planning documents at the Reserve Banks we visited revealed that examiners are using a variety of methods for preparing the risk assessments and scoping memoranda for community banks. Some examiners used the six risk factors in the Board policy for conducting the risk assessment, then prepared a scope memorandum addressing the CAMELS components. In these cases, it was not always clear how ratings of the six risk factors translated into procedures included in the examination plan. At one Reserve Bank, examiners prepared a risk profile of the institution that identified the significant activities in the institution but did not evaluate the activities along the six risk factors. Examiners at another Reserve Bank used a matrix to identify significant activities, assess the associated risks, and plan the procedures to be performed during the examination.

We believe the Director of BS&R should, after considering best practices of the Reserve Banks, issue supplemental guidance that links the six risk factors with the examination procedure modules that are designed around the CAMELS components. Since the framework was developed jointly with FDIC, which does not use the risk factors adopted by the Federal Reserve, incorporating the six risk factors into the framework may not be feasible. In our opinion, a matrix that identifies significant activities and functions within a community bank, rates their associated risks using the six risk factors, and identifies the examination scope for each activity and function may be the best tool for planning and scoping examinations of community banks. The Federal Reserve's framework for risk-focused supervision of large complex institutions incorporates a risk matrix that ties together the activities, the types and levels of inherent risks, and the adequacy of risk management over the activities. Accordingly, we believe a similar matrix could be an effective tool for planning community bank examinations and promoting examination consistency among Reserve Banks.

4. We recommend that the Director of BS&R revise the content of examination reports to reflect the risk-focused examination approach.

The report of examination is the primary vehicle used to communicate examination conclusions, findings, and recommendations to the management and directors of a bank. The Board's *Commercial Bank Examination Manual* outlines the detailed formats and analyses that are required to be included on examination report pages. Although the manual adheres to an interagency mandate that "core" report pages address an examiner's conclusions and provide information on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS), the Federal Reserve otherwise has considerable discretion to specify the format and contents of its examination reports.

In our opinion, reports of examination should reflect the concepts and issues emphasized under the risk-focused approach. Bankers surveyed for a BS&R study on supervision practices as well as many Reserve Bank examiners and officers we interviewed agree that much of the detailed financial information adds little, if any, value to examination reports. Based on our analysis of risk-focused supervision principles, we believe that unnecessary data eliminated from examination reports should be replaced by an enhanced analysis and discussion of an institution's risk profile and risk management systems along with a forward-looking assessment of how a financial institution is positioned to manage current and future risks. A streamlined report of examination that is tailored to an institution's risk profile will provide more timely, value-added information to the bank's management and board of directors. Any guidance on revising reports of examination must take into account the fact that more detailed reporting will be needed to justify examiner conclusions and CAMELS ratings for troubled or deteriorating institutions.

5. We recommend that the Director of BS&R provide opportunities for division analysts, who are responsible for developing examination policies and procedures, to participate in field examinations.

BS&R financial analysts need a broad-based understanding and thorough working knowledge of the banking industry, regulatory environment, and supervisory issues to effectively develop and update supervisory policies, procedures, and examination tools. Board and Reserve Bank staff we interviewed believe that analysts' periodic participation in examinations would enhance their understanding of banking industry dynamics and Reserve Bank examination practices. In our opinion, analysts' participation in examinations would result in more effective development of policies and procedures and identification of areas where revisions or clarifications are needed. While we recognize that implementing this recommendation will affect the division's budget for travel and training, we believe that periodic participation in examinations would improve the analysts understanding of emerging issues in the banking industry and enhance the overall supervisory program.

6. We recommend that the Director of BS&R add an on-the-job training component to the existing training program to help less experienced examiners develop skills required to conduct risk-focused examinations.

When planning the scope of risk-focused supervisory reviews, examiners need to use their judgement and knowledge of the institution to determine the level of resources required to assess a bank's risk management processes and the amount of transaction testing necessary to substantiate that the bank's management systems are operating effectively. Management at several Reserve Banks we visited expressed concern that the risk-focused approach to supervision may not allow sufficient time and depth of review to provide newer examiners with the work experience needed to develop the judgement required to plan and conduct risk-focused examinations. Some Reserve Banks have recognized this paradox and have devoted time to staff training during examinations to provide newer examiners with relevant work experience, even though the additional work performed may not have been indicated by the risks identified in the planning process.

BS&R has recognized the potential benefits of adding an on-the-job training (OJT) component to the existing training program and has considered various methods of administering it. We believe the risk-focused approach heightens the need for a formal program to help less experienced examiners develop and maintain the skills required to conduct risk-focused examinations. While some Reserve Banks already use informal OJT to develop less experienced staff, we believe that a formal program that clearly defines training objectives and is integrated with the classroom curriculum would provide examiners a better opportunity for performing newly learned examination procedures in a "real-world" setting. We recognize that implementing a structured program may require spending additional examination resources on some supervisory reviews, but we believe that the benefits of developing newer examiners' ability to conduct risk-focused exams is worth the expenditure.

7. **We recommend that the Director of BS&R communicate directly with Reserve Bank examiners to reiterate the division's commitment and support of risk-focused examination practices.**

Because risk-focused examination practices vary significantly from traditional examination procedures, certain examiners have been reluctant to fully implement the new approach. Examiners and supervisors we interviewed told us that it is difficult to make the transition from longstanding practices that featured an array of transaction testing procedures for every exam to the risk-focused framework that emphasizes focusing examiner time only on areas that pose material risk to an institution's safety and soundness. We found that to some degree, examiner reluctance in adopting the risk-focused approach stems from a fear that decisions to eliminate low risk areas from an examination will later be questioned by Reserve Bank management as well as Board staff, particularly if problems evolve in the future. We observed that some Reserve Bank managers are aware of this issue and are demonstrating their acceptance of examiners' risk-focused judgments by signing off on the scoping memos prepared by the Examiner-in-Charge. We believe that the recent Board guidance on conducting risk-focused community bank examinations, the June 1997 senior examiners' conference on the risk-focused approach, and Board-sponsored training at the Reserve Banks have been helpful in introducing the new framework. Nevertheless, discussions with staff at Reserve Banks indicated that direct communication from senior BS&R management to reiterate the System's commitment to the risk-focused examination concept could help accelerate and solidify examiner acceptance of the new approach. While there are numerous ways that this message could be communicated, we believe that a videotape would be a particularly flexible, efficient, and effective vehicle.

8. **We recommend that the Director of BS&R establish a process to monitor the System's progress in implementing the risk-focused approach to bank supervision and to disseminate information on what are judged best practices.**

As noted earlier, some examiners are having difficulty adapting to the risk-focused approach because it varies so dramatically from traditional Federal Reserve procedures for planning and conducting supervisory reviews. To successfully implement the new approach, BS&R has to control the risks that accompany such a major change in the process for examining financial institutions. These risks include the potential for inconsistent implementation among the Reserve Banks and independent development of different or supplemental procedures that are not communicated and adopted System wide. To deal with these risks, we believe that BS&R should establish a process to track the System's progress in implementing risk-focused examinations. This process should (1) ensure that sufficient information is available to compare experiences across Federal Reserve Districts, (2) gauge progress in achieving the goals and objectives of the risk-focused approach, and (3) provide Systemwide access to information on successful implementation strategies and best practices.

ANALYSIS OF COMMENTS

We provided a draft copy of this report to the Director of BS&R for his review and comment. His response (appendix 1, page 19) discusses numerous efforts taken by the System to develop and implement the risk-focused supervision framework for community banks. His responses appear to fall into three categories: general agreement, partial agreement, and general disagreement.

He seems to generally agree with our recommendations to expand ongoing coordination with other regulators (recommendation 1), revise incompatible supervisory policies (recommendation 2), enable BS&R staff to participate in field examinations (recommendation 5), and monitor System implementation of the risk-focused approach and disseminate best practices (recommendation 8).

He appears to agree in part with adding an OJT component to existing classroom training to help less experienced examiners develop the skills required to conduct risk-focused examinations (recommendation 6), but questions whether a "structured" OJT program is the preferred delivery mechanism. During our audit, management at several Reserve Banks expressed concern that the risk-focused approach to supervision may not allow sufficient time and depth of review to provide newer examiners with the work experience needed to develop the judgement required to plan and conduct risk-focused examinations. Even though the additional work performed may not be warranted by the risk indicated in the planning process, staff OJT during the examinations is necessary to provide newer examiners with relevant work experience. The response to recommendation 7 indicates partial agreement with his communicating directly with Reserve Bank examiners to mitigate some of the examiners' reluctance to fully implement the new approach.

He appears to generally disagree with recommendations 3 and 4; however, his responses reflect a willingness to give ongoing attention to these recommendations using several recently formed advisory groups chartered to address related issues. We continue to believe that supplemental guidance is required that links the six risk factors with the examination procedure modules that are designed around the CAMELS components (recommendation 3). We also continue to support the preparation of a streamlined report of examination that is tailored to an institution's risk profile and provides timely, value-added information to bank management and its board of directors (recommendation 4).

We plan to conduct a review of the System's overall progress with the risk-focused approach during our follow-up of this audit.

APPENDIXES

Appendix 1 - Division's Comments

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

February 9, 1998

Mr. Brent L. Bowen
Office of the Inspector General
Board of Governors of the
Federal Reserve System

Dear Brent,

Thank you for giving the staff of the Division of Banking Supervision and Regulation (BS&R) the opportunity to comment on your draft report Audit of the Federal Reserve's Implementation of the Risk-Focused Approach to Supervising Community Banks (A9709).

The report is based on an audit the IG conducted during September and October 1997 to evaluate the Federal Reserve's experiences in developing and implementing the risk-focused supervision framework for community banks and to provide early feedback to assist BS&R in fine tuning the framework. Overall, your draft report indicates that the Federal Reserve System is making substantial progress in adopting the risk-focused supervision framework for community banks. Recognizing the solid progress to date, the report makes several recommendations to enhance the efficiency and effectiveness of the framework. While many of the IG's recommendations were in the process of being implemented at the time of the audit, we will carefully consider each recommendation as the Division fully develops the risk-focused framework for community banks.

As the IG is aware, the risk-focused supervision framework for community banks was implemented on October 1, 1997 by the Federal Reserve System in concert with the Federal Deposit Insurance Corporation (FDIC). This was a major undertaking by the Federal Reserve and the FDIC and reflects the agencies' commitment to ensuring that our processes for supervising community banks are consistent and responsive to the changes taking place in the banking industry. Recognizing that we are still in the early phase of implementing the risk-focused framework, the Division expects that additional examiner guidance and training will be necessary as experience is gained with the framework and the examination procedures. For this reason, we have established a System advisory group with representatives from several of the Reserve Banks and BS&R staff to address policy issues and questions arising from the implementation of the risk-focused supervision framework for community banks. Further, BS&R staff is continuing to work closely with the FDIC on maintaining this framework and developing an electronic platform for the supervision of community banks. The attachment responds to the eight recommendations contained in the IG's report.

We appreciate the opportunity to comment on the IG's draft report.

Sincerely,

Richard Spillenkothen
Director

Attachment

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BS&R Division Comments on
The Inspector General's Report on the Audit of the Federal Reserve's
Implementation of the Risk-Focused Approach to
Supervising Community Banks

1. **Recommendation: the Director of BS&R should expand on-going coordination with federal and state regulators to achieve a uniform, risk-focused examination program for state-chartered banks.**

Response: Much has been accomplished over the past two years to foster coordination with the FDIC and the state regulators. In May 1996, the Federal Reserve, the FDIC, and the Conference of State Bank Supervisors issued the State/Federal Supervisory Protocol and Model Agreement. Under the protocol, the home state supervisor and the appropriate federal regulator agreed to coordinate the supervision of interstate banks to ensure a risk-focused process and to reduce regulatory burden and overlap. Based on the Model Agreement, the Federal Reserve, the FDIC, and all of the state banking departments signed a Nationwide State/Federal Supervisory Agreement in November 1996. This agreement outlines a "best efforts" supervisory approach. In October 1997, the Federal Reserve and the FDIC jointly adopted a risk-focused supervision framework for community banks, including jointly developed examination procedures. To date, over half of the state banking departments have also adopted the framework and are implementing the examination procedures. The State/Federal Working Group, which was responsible for these past efforts, is still active and continues its leadership role in fostering coordination efforts among the federal and state regulators. Moreover, the Division Director is an active member of the Working Group and the Division's Deputy Director chairs the Working Group's examination subcommittee.

The Federal Reserve and the FDIC have also formed a committee to maintain the examination modules for community banks. This committee is scheduled to meet on a quarterly basis to consider changes to existing modules as well as to consider developing new examination modules.

The Federal Reserve has also committed staff to a joint project of the FDIC, Federal Reserve, and Conference of State Bank Supervisors with the objective of developing an electronic platform for the supervision of community banks. Presently, the major focus of this project is the preparation of the report of examination. This will include an automated download of financial data to the report of examination.

Notwithstanding these efforts to coordinate the examination of state-chartered banks with the FDIC, BS&R staff believes that the need to be innovative and responsive to the banking industry makes it difficult to achieve complete uniformity on supervisory policy. While BS&R staff will continue to work closely with FDIC staff on supervisory policies, there may be instances when separate guidance will be issued to address agency specific issues and concerns.

2. **Recommendation: the Director of BS&R should revise supervisory policies that are incompatible with the risk-focused examination approach.**

Response: Recently, a Federal Reserve System advisory group was formed to address policy issues arising from the implementation of the risk-focused framework for community banks. The group includes representatives from several of the Reserve Banks and BS&R staff from the policy and supervision areas. The group has already identified several SR letters which probably will need to be revised or superseded. Members of the group have been assigned responsibility to review these letters and to determine whether to modify or eliminate the examiner guidance contained in those letters.

Further, earlier this year, staff from the Dallas and Kansas City Reserve Banks, volunteered to review SR letters to identify those SR letters containing guidance that might inhibit the implementation of the risk-focused framework. This review was completed in December and is being used by the working group in their efforts to revise existing supervisory policies.

3. **Recommendation: the Director of BS&R should issue supplemental guidance to integrate the Federal Reserve's six risk assessment criteria with the CAMELS format in the joint Federal Reserve/FDIC framework for examining community banks.**

Response: In 1996, the agencies revised the Uniform Financial Rating System (better known as CAMELS) to include an explicit reference to the quality of risk management processes in the management component and the identification of risk elements within the composite and component rating descriptions. Under the revised rating system, the descriptions accompanying each component emphasize the need to reflect in the rating, management's ability to identify, measure, monitor, and control risks.

There are some difficulties in translating the six risk criteria into the CAMELS format. In mapping the individual risks to the CAMELS rating, there is some overlap. For example, credit risk is present in "C" - capital, "A" - asset quality, and "M"-management. In addition, this is an area where examiner judgment is important, and it is not clear that a matrix or formula will provide the necessary flexibility. Consequently, at this time, and given the difficulties noted, we do not believe the expected benefits from this suggestion would outweigh the drawbacks. However, this is an issue that has received attention by the groups developing the examination modules and the overall risk-focused framework. We will continue to discuss with the FDIC and work with the advisory group to evaluate the need for additional guidance on incorporating risk assessments into the CAMELS format.

4. **Recommendation: the Director of BS&R should revise the content of examination reports to reflect the risk-focused examination approach.**

Response: In September 1993, the Federal Reserve entered into an agreement with the other banking agencies and the Office of Thrift Supervision to utilize a uniform interagency common "core" report of examination. The report of examination consists of three parts: mandatory core section, optional core pages, and supplemental information. The mandatory core section addresses examiners' overall conclusions and provides information on the CAMELS rating. The common core pages require examiners to follow minimum standards on reporting information while allowing each agency the flexibility to establish its own financial data requirements. The supplemental information allows each agency to report information of interest to the agency or information necessitated by the particular examination.

BS&R staff believes that the present report format is adequate and provides sufficient flexibility to allow examiners to report their analysis on a risk-focused basis. Since the risk-focused framework was only implemented in October 1997, it is expected that as examiners gain experience with the risk-focused procedures, discussions in the report of examination will become more risk-focused. It is important that the report strike the right balance between the qualitative and quantative information it conveys, but at the same time it should contain sufficient quantative information to support examiners' analysis. The present format provides examiners with some degree of judgment as to the level of detail of financial data to incorporate into the report. Further, the report format recognizes that there are many users of the report of examination and that the inclusion of some financial information is necessary to meet the needs of the various users. The advisory group on the risk-focused framework for community banks will be asked to consider the IG's recommendation to determine if there is a need for additional guidance on report preparation or to revise the report format.

5. **Recommendation: the Director of BS&R should provide opportunities for division analysts, who are responsible for developing examination policies and procedures, to participate in field examinations.**

Response: BS&R staff has been and will continue to be encouraged to participate in field examinations. For example, there are several supervisory exercises now underway in which BS&R staff are participating in targeted examination to better understand risks in global banking activities. Nonetheless, broad implementation of this recommendation would have budgetary implications that must be taken into account when considering the benefits. The Division was able to increase its travel budget for the years 1998 and 1999 to fund the Division's increasing travel requirements, including the need to provide training opportunities to staff.

6. **Recommendation: the Director of BS&R should add an On-the-Job Training component to the existing training program to help less experienced examiners develop skills required to conduct risk-focused examinations.**

   Response: On-the-job training is already a principal vehicle for developing examiner skills and experience and a major element of examiner training. As a matter of practice, Reserve Banks supplement the examination team with newly hired examiners to specifically provide these individuals with on-the-job training. The challenge we face moving forward is how best to integrate the risk-focused supervision framework into our examiner training program. In 1997, the core curriculum review group recommended a new training program for assistant examiners that incorporates the risk-focused supervision framework. The program was approved by the System senior management in the fall of 1997 and implementation began in October 1997. Whether a structured on-the-job training program is the preferred delivery mechanism to accomplish this objective will be assessed as the overall program is implemented.

7. **Recommendation: the Director of BS&R should communicate directly with Reserve Bank examiners to reiterate the division's commitment and support of risk-focused examination practices.**

   Response: The Director of BS&R and the senior officers of the division are committed to maintaining a high level of communications with Reserve Bank examiners and officers. Indeed, the Director meets quarterly with the Reserve Bank officers in charge of supervision and takes every opportunity to meet with examiners whenever possible. We also use SR letters as a primary form of communication with supervisory personnel to explain supervisory policies and to implement examination procedures. The importance we place on SR letters as a form of communications with examiners was underscored by a recent change in our traditional format for addressing recipients of the letters. Previously, SR letters were directed to the senior officers in charge of supervision at each of the Federal Reserve Banks. Going forward, when guidance is intended for a wider audience of supervisory personnel, SR letters will be addressed to System examiners, as well as senior officers. With the advent of the Internet, ready access to SR letters by examiners has improved as the letters are immediately placed on the BS&R Web site, which also provides access to our examiner manuals.

   To introduce the risk-focused framework, BS&R staff, assisted by Reserve Bank staff, held training sessions on the risk-focused framework for community banks at most of the Reserve Banks and major branches. Several of the Reserve Banks requested follow-up training on the automated examination modules (Elvis), which the BS&R staff has also conducted. Further, Elvis has an e-mail feature that allows an examiner to send comments on the content of the procedures to the maintenance committee as well as questions on the Elvis program to the program developer.

To reinforce the overall objectives of the risk-focused supervision framework, senior officers, including the Director, of the division have spoken at examiner training sessions at several Reserve Banks. It is anticipated that these speaking engagements will continue. Moreover, the division will also be holding the senior examiner forum again this year to discuss the current supervisory activities and the implementation of the risk-focused framework. This forum is attended by over 150 senior examiners from across the Federal Reserve System and has proven to be an excellent opportunity for communicating and discussing supervisory initiatives and policies.

8. **Recommendation: the Director of BS&R should establish a process to monitor the System's progress in implementing the risk-focused approach to bank supervision and to disseminate information on what are judged best practices.**

   Response: As part of the implementation of the risk-focused framework, a contact person was identified at each of the Reserve Banks to act as advisor and to disseminate best practices on the risk-focused framework in their districts. To date, the contacts have assisted in the training held at the Reserve Banks to introduce the risk-focused framework. In the second quarter of 1998, BS&R staff intends to call upon these individuals to discuss implementation issues and best practices. It was felt that Reserve Banks needed to have at least six months of experience with the program before holding discussions. The recently formed advisory group for the community banks has also been tasked with developing guidance for examiners as experience is gained from the risk-focused framework and the examination modules. In addition to these initiatives, the Division is considering other alternatives for monitoring progress in implementing the risk-focused framework, including: a review of a sample of scope memorandums and report of examinations and on-site visits by BS&R staff to the Reserve Banks. We also expect that the Board's and Reserve Banks' report review processes will be an important mechanism for monitoring implementation of the framework.

Appendix 2 - Principal OIG Contributors to this Report

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